

Message Text

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PAGE 01 BRASIL 07181 181322Z

47

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PASS TREASURY FOR NATHAN GORDON AND ROBERT PELIKAN

E. O. 111652: N/A

TAGS: EFIN, BR

SUBJ: BRAZIL CHANGES SYSTEM OF TAXING INTEREST

REMITTED ON FOREIGN LOANS

1. BY VIRTUE OF DECREE LAW 1411 OF AUGUST 6, 1975, THE INCOME TAX ON INTEREST, COMMISSIONS AND EXPENSES REMITTED ON FOREIGN LOANS HAS BEEN INCREASED TO 25 PERCENT FROM 5 PERCENT, WHILE AT THE SAME TIME THE LOCAL (BRAZILIAN) BORROWER WILL BE GRANTED A MONETARY BENEFIT (BENEFICIO PECUNIARIO) AMOUNTING TO 85 PERCENT OF TAX PAID. INESSENCE, THE EFFECTIVE INCOME TAX RATE ON INTEREST REMITTED HAS BEEN DECREASED, FOR THE LOCAL BORROWER, FROM 5 PERCENT TO 3.75 PERCENT (25 PERCENT-21.25 PERCENT).

COMMENT:

2. CENTRAL BANK OFFICIALS, IN DISCUSSIONS WITH FINATT, HAVE INDICATED TWO BASIC REASONS UNDERLYING
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PAGE 02 BRASIL 07181 181322Z

THIS REVISION (A) TO DECREASE THE COST OF FOREIGN

BORROWING, AND (B) TO ELIMINATE A PECULIARITY BROUGHT ABOUT BY THE PREVIOUS REDUCTION IN THE RATE TO 5 PERCENT FROM 25 PERCENT WHICH HAD THE EFFECT OF INCREASING (INSTEAD OF DECREASING) THE INTEREST COST OF SOME FOREIGN BORROWINGS.

3. WITH RESPECT TO POINT (B) ABOVE, THE EXPLANATION IS THE FOLLOWING: WITH THE REDUCED (5 PERCENT) TAX RATE, LENDERS RECEIVED A LOWER FOREIGN TAX CREDIT TO OFFSET THE DOMESTIC (HOME OFFICE) TAX LIABILITY, AND THUS WERE REQUIRED TO PAY HIGHER INCOME TAXES. WITH A HIGHER TAX BILL, SOME FOREIGN BANKS, IN ORDER TO MAINTAIN A CERTAIN LEVEL OF AFTER-TAX INCOME, HAD REPORTEDLY INCREASED THEIR NET-OF-TAX INTEREST RATE ON LOANS TO BRAZIL. THIS WAS A PECULIAR, AND UN-SATISFACTORY POSITION FOR BRAZIL, BECAUSE, WHILE THE FOREIGN LENDER RECEIVED THE SAME INCOME AS BEFORE THE TAX WAS REDUCED, THE FOREIGN EXCHANGE OUTFLOW FROM BRAZIL (I.E., THE INTEREST PAYMENT) WAS HIGHER. WHAT THE PREVIOUS REDUCTION IN THE INCOME TAX RATE TO 5 PERCENT HAD IN EFFECT DONE WAS TO CAUSE A TRANSFER OF TAX REVENUES FROM THE BRAZILIAN TREASURY TO THE TAX COFFERS OF SOME OF THE LENDING COUNTRIES, WITH AN ADVERSE IMPACT ON BRAZIL'S BALANCE OF PAYMENTS.

4. THE MONETARY BENEFIT ASPECT OF THIS REVISION RAISES AN INTERESTING, AND, FOR US NON-EXPERTS IN TAX MATTERS, AN UNANSWERABLE QUESTION INsofar AS US BANKS ARE CONCERNED. THE QUESTION IS WHETHER U.S. BANKS WILL BE PERMITTED TO CLAIM THE FULL 25 PERCENT OF THE BRAZILIAN TAX AS A FOREIGN TAX CREDIT WHEN THE LOCAL BORROWER IN FACT IS BEING RETURNED 85 PERCENT OF THIS AMOUNT. WHEN FINATT RAISED THIS AS A POSSIBLE PROBLEM WITH THE CENTRAL BANK DIRECTOR FOR EXTERNAL AFFAIRS, THE DIRECTOR SAID THAT, UNDER BRAZILIAN TAX LEGISLATION, THE WAY THE 85 PERCENT IS BEING HANDLED IT IS CONSIDERED SEPARATE FROM AN UNRELATED TO THE INCOME TAX COLLECTED. HE SAID THE TAX AUTHORITIES HAVE ESTABLISHED TWO SEPARATE ACCOUNTS TO HANDLE THE TAX REVENUE AND THE LIMITED OFFICIAL USE

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PAGE 03 BRASIL 07181 181322Z

MONETARY BENEFIT. HE MAINTAINED, IN VERY POSITIVE TERMS, THAT UNDER BRAZILIAN LEGISLATION THE 85 PERCENT WAS NOT RPT NOT A TAX REBATE. HE CLAIMED THAT THIS ASPECT HAD BEEN DISCUSSED WHEN THE PROPOSAL WAS UNDER CONSIDERATION AND THAT THE TWO SEPARATE ACCOUNTS APPROACH WAS IMPLEMENTED TO AVOID A DIRECT CONNECTION BETWEEN THE 25 PERCENT TAX REVENUE AND THE 85 PERCENT MONETARY BENEFIT. AS BEST AS WE CAN

INTERPRET IT, THE BRAZILIAN AUTHORITIES VIEW THE MONETARY BENEFIT AS A GENERAL INCENTIVE TO FOREIGN BORROWING, AND A SOLUTION TO THE PECULIAR SITUATION EXISTING UNDER THE PREVIOUS TAX SYSTEM (DESCRIBED ABOVE).

5. ACTION REQUESTED: ANY GUIDANCE MR. GORDON CAN PROVIDE ON THE POSSIBLE INTERPRETATION BY U.S. TAX AUTHORITIES OF THE 85 PERCENT MONETARY BENEFIT IN TERMS OF THE ELIGIBILITY OF THE 25 PERCENT BRAZILIAN TAX AS A FOREIGN TAX CREDIT WOULD BE APPRECIATED. IT WOULD HELP US IN FURTHER DISCUSSIONS OF THIS MATTER WITH CENTRAL BANK OFFICIALS AND WITH REPRESENTATIVES OF U.S. BANKS IN BRAZIL.
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